

## Message Text

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ACTION NEA-12

INFO OCT-01 ISO-00 CIAE-00 DODE-00 PM-07 H-03 INR-10 L-03

NSAE-00 NSC-10 PA-04 RSC-01 PRS-01 SPC-03 SS-20

USIA-15 SAM-01 STR-08 CEA-02 AID-20 COME-00 EB-11

FRB-02 TRSE-00 XMB-07 OPIC-12 CIEP-02 LAB-06 SIL-01

OMB-01 DRC-01 /164 W

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R 250930Z FEB 74

FM AMEMBASSY TEL AVIV

TO SECSTATE WASHDC 1636

INFO AMEMBASSY AMMAN

AMEMBASSY BEIRUT

USINT CAIRO

AMCONSUL JERUSALX

C O N F I D E N T I A L SECTION 1 OF 2 TEL AVIV 1081

E.O. 11652: GDS

TAGS: ECON, EAID, IS

SUBJ: ECONOMIC PROBLEMS FACING NEXT GOVERNMENT

AND IMPLICATIONS FOR USG

1. SUMMARY. NEXT GOVERNMENT WILL HAVE TO FACE MAJOR DECISIONS ON ISRAELI'S MANIFOLD ECONOMIC GOALS, AND SPEED WITH WHICH THEY CAN BE ATTAINED. THESE WILL INVOLVE ACTION ON NUMBER OF SUBSIDIARY AND INTERCONNECTED FRONTS, INCLUDING INFLATION, HOUSING, EXCHANGE RATE OF ISRAEL POUND, FISCAL POLICY (ULTIMATE SIZE OF GOVT BUDGET AND ITS FINANCING), AND NATIONAL STANDARD OF LIVING. INFLATION EXCEEDED 26 PERCENT IN 1973, WHILE 30-35 PERCENT IN 1974 IS THREATENED. DRIVING FORCE BEHIND INFLATION LAST YEAR WAS OVERBLOWN CONSTRUCTION SECTOR (I.E. MAINLY HOUSING), WHICH WILL IF ANYTHING FACE EVEN MORE SEVERE DEMAND PRESSURES IN 1974. HOUSING PROBLEM IS NOT ONE OF MONEY; CONSTRUCTION INDUSTRY IS SIMPLY UNABLE TO BUILD ENOUGH HOUSING TO MEET DEMAND. RAPID PACE OF INFLATION ENSURES THAT ISRAEL POUND WILL ULTIMATELY  
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HAVE TO BE DEVALUED (PROBABLY IN NEAR FUTURE), DESPITE FINANCE

MINISTER'S RELUCTANCE. FISCAL POLICY CONSTITUTES SINGLE MOST IMPORTANT ECONOMIC FACTOR IN EQUATION, SINCE GOI WILL APPARENTLY BE SPENDING DIRECTLY OVER THREE- FOURTHS OF GROSS NATIONAL PRODUCT. PRELIMINARY INDICATIONS ARE THAT TAXES WILL BE REDUCED AS FROM APRIL 1, 1974. NONETHELESS GOI IS ATTEMPTING TO ROLL BACK ISRAEL'S STANDARD OF LIVING TO 1972 LEVEL, WHICH WOULD MEAN CUT IN STANDARDLIVINGOF 10 PERCENT IN REAL TERMS. ISRAELIS ARE UNDERSTANDABLY RESISTING THIS REDUCTION, BUT INFLATION IS " TAXING" IT AWAY ANYWAY. DURING 1973, GOI WAS UNMISTAKABLY OVEREXTENDED ECONOMICALLY, TRYING TO DO TOO MUCH TOO QUICKLY. RESULT HAS BEEN BRUTAL RATE OF INFLATION WHICH INEVITABLY HAD AND WILL HAVE POLITICAL FALLOUT, ADVERSE TO ELECTORAL PROSPECTS OF LABOR ALIGNMENT. AVAILABILITY OF GENEROUS USG ASSISTANCE SINCE 197, EXCEEDING ISRAEL'S BOP REQUIREMENTS, HAS PERMITTED ACCUMULATION OF SUBSTANTIAL RESERVES, AND ENCOURAGED ISRAEL TO UNDERTAKE BREADTH OF ECONOMIC ACTIVITIES BEYOND LIMITS WHICH REAL RESOURCES AVAILABLE CAN SUSTAIN. THE RESULTING INFLATION HAS PLAYED ITS TRADITIONAL ROLE IN STUNTING EXPORTS, STIMULATING IMPORTS, AND THUS INCREASING "REQUIREMENTS" FOR AID. CONTINUATION ALONG THESE LINES IS NOT IN INTERESTS OF ISRAEL OR UNITED STATES. FOREGOING IS NOT IN CONFLICT WITH RECOMMENDATIONS IN TEL AVIV 0801 ON USG AID, BUT SUGGESTS USG CONSIDER ECONOMIC IMPACT OF IT PROGRAMS ON ISRAEL AS WELL AS POLITICAL EFFDYTS. END SUMMARY.

2. DURING 1974, GOI WILL FACE MAJOR ECONOMIC PROBLEMS. IN SOME CASES THESE ARE NOT NEW BUT OUTGROWTHS OF TRENDS LONG PREVALENT; AMONG THESE ARE INFLATION, HOUSING, AND EXCHANGE RATE OF ISRAEL POUND. OTHERS HAVE BEEN PROFOUNDLY TRANSFORMED BY OCTOBER WAR: THESE INCLUDE GOVT BUDGET AND ITS FINANCING, AND NATIONAL STANDARD OF LIVING. ALL ARE INTRICATELY INTERCONNECTED.

3. RISE IN CONSUMER PRICE INDEX OF 26.4 PERCENT EXPERIENCED BY ISRAEL DURING 1973 MARKS DECISIVE BREAK WITH PAST. THERE HAS BEEN NOTING REMOTELY LIKE IT FOR TWENTLY YEARS, AND EVEN THEN HIGHER RATES ATTAINED IN 1952 AND 1953 WERE ATTRIBUTABLE IN LARGE PART TO HUGE DEVALUATIONS. IN 1973 THERE WAS NO SUCH EXCUSE. WHILE WAR ADDED A FEW PERCENTAGE POINTS TO FIGURE, EVEN WITHOUT WAR IT WOULD HAVE BEEN ABOUT 22 PERCENT. ONCE INFLATION HAS REACHED THIS LEVEL, IT IS HEARTBREAKINGLY DIFFICULT TO CONTROL; WE MAY BE WITNESSING LATIN CONFIDENTIAL

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AMERICANIZATION OF ISRAEL IN THIS RESPECT. OUR FORCAST FOR 1974 IS 30-35 PERCENT. IT IS NOW CERTAIN THAT CONSUMER PRICE INDEX WILL RISE ABOUT 10 PERCENT DURING FIRST TWO MONTHS ALONE, A RESULT HEAVILY INFLUENCED BY INCREASES IN CONTROLLED PRICES OF STAPLES AND CANCELLATION OF SUBSIDIES.

4. PERVASIVE PHEONOMEON OF LINKAGE (TO CONSUMER PRICE INDEX) TRANSFERS RISE IN PRICES THROUGHOUT ECONOMY. COST-OF-LIVING ADJUSTMENTS

(COLA) FOR WAGES ARE ONE EXAMPLE. NOT ONLY HAVE WE RETURNED TO SEMI-ANNUAL COLA (1973 WAS FIRST TIME SINCE 1964 A MID-YEAR COLA WAS REQUIRED), BUT WE ARE ALREADY BEYOND THAT, WITH UNSCHEDULED FEBRUARY COLA DUE TO SUBSIDY REDUCTIONS. ANOTHER EXAMPLE IS INTEREST RATES, WHICH INFLUENCE SAVINGS. HIGH RATE OF INFLATION THREATENS VALUE OF SAVINGS; TO COUNTERACT IT PEOPLE HAVE BEEN TURNING TO GOVT SECURITIES WITH PRINCIPAL AND INTEREST LINKED. HOWEVER, THIS HAS RUN UP INTERNAL DEBT OF ISRAEL SO QUICKLY THAT GOVERNMENT HAS JUST ACTED TO ALTER TERMS, LEAVING PRINCIPAL LINKED, BUT UNLINKING INTEREST. THIS IS BOUND TO ADVERSELY AFFECT DOMESTIC SAVINGS AND STIMULATE CAPITAL FLIGHT INTO PROPERTY (I.E. HOUSING) TO PROTECT VALUE OF SAVINGS.

5. HOUSING IS BIGGEST SOCIAL PROBLEM IN ISRAEL; EFFECTIVE DEMAND FOR HOUSING (BACKED UP BY FINANCING) EXCEEDS AMOUNT WHICH CAN BE BUILT WITH AVAILABLE MANPOWER AND OTHER RESOURCES; THOUGH RATE OF HOUSING STARTS PER CAPIA IN ISRAEL (BEFORE WAR) WAS VERY HIGH BY WORLD STANDARDS. AS RESULT CERTAIN CATEGORIES OF BUYERS HAVE BEEN FAVORED: IMMIGRANTS, THE SOCIALLY AND ECONOMICALLY DEPRIVED, AND YOUNG COUPLES, TO WHICH MUST NOW BE ADDED DEMOBILIZED SOLDIERS. CONSTRUCTION INDUSTRY IS LEADING ECONOMIC SECTOR IN ISRAEL, LIKE AUTOMOBILES IN UNITED STATES. IT WAS GREATLY OVEREXPANDED BEFORE OCTOBER WAR, AS ALL INFORMED OBSERVERS CONCEDED. ON REASON IT TAKES TWICE AS LONG TO BUILD IN ISRAEL AS IT DOES IN UNITED STATES, IS BECAUSE THERE ARE INSUFFICIENT SKILLED WORKMAN (PLUMBERS, ELECTRICIANS, GLAZIERS, TILELAYERS) TO FINISH OFF BUILDINGS STARTED. IN POST WAR ECONOMY, DEMAND FOR HOUSING IS UNLIKELY TO ABATE, WITH DEMOBILIZED SOLDIERS AND EAGER INVESTORS ADDED TO PREWAR DEMAND, AT TIME WHEN LESS LABOR IS AVAILABLE (DUE TO HIGHER MILITARY MOBILIZATION LEVEL AND FEWER ARAB WORKMEN), AND WHILE GOI IS TRYING TO EXPAND DEFENSE INDUSTRIES. TRAFFIC JAM OF COMPETING DEMANDS ON CONSTRUCTION INDUSTRY IMPENDS, ALONG WITH NEED TO SET NATION PRIORITIES. BUT POLITICAIN  
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WITH COURAGE ENOUGH TO TELL ISRAELIS THAT HOUSING WILL HAVE TO WAIT IS NOT IN SIGHT.  
IF HE IS NOT FOUND, DOUBLING OF HOUSING COSTS IN PAST FOUR YEARS WILL BE " BETTERED."

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C O N F I D E N T I A L SECTION 2 OF 2 TEL AVIV 1081

6. SAPIR IS STRONGLY AGAINST DEVALUATION OF ISRAEL POUND, OUT OF CONVICTION THAT DEMAND FOR ISRAEL'S MAIN EXPORTS (CITRUS, TOURISM, DIAMONDS) IS INELASTIC, AND HENCE ISRAEL CAN ONLY LOSE FROM LOWER PRICES. (E.G. DIAMOND PRICES ARE SET BY CARTEL; ORANGES FACE EUROPEAN REFERENCE PRICE.) INCREASE IN EXPORT INCENTIVES JUST ANNOUNCED RETROACTIVE TO NOVEMBER 6 IS SAPIR'S ANSWER TO SEVERE PRESSURES PUSHING ISRAEL TOWARD DEVALUATION; IT IS TEMPORARY PALLIATIVE. BUT RAPID PACE OF INFLATION ENSURES THAT SAPIR WILL ULTIMATELY BE OVERBORNE BY EVENTS, AND PROBABLY IN NEAR FUTURE. GRAY MARKET HAS ALREADY DEVALUED POUND; TOURIST CAN GET IL 5.00 PER DOLLAR OR MORE IN EAST JERUSALEM OR IN TEL AVIV'S LILIEBLUM STREET. GOVT IS EXPERIENCING INCREASING DIFFICULTY IN FINDING SUBSIDIES AND OTHER GIMMICKS TO STAVE OFF INEVITABLE. (EXPORT INCENTIVES PUT HEAVY PRESSURE ON BUDGET SORELY STRAINED BY DEFENSE EXPENDITURES. AT SOME POINT SAVINGS OF IL 1.5 BILLION ON SUBSIDIES WHICH DEVALUATION WOULD PERMIT IS GOING TO SEEM ATTRACTIVE.) SOMETHING WILL HAVE TO GIVE. RATE MIGHT GO AS FAR AS IL 6 PER DOLLAR, BUT PERHAPS IL 5.50 PER DOLLAR IS MORE LIKELY.

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7. GOVERNMENT BUDGET FOR FY 1973/74 ROSE FROM ORIGINALLY APPROVED IL 20 BILLION TO OVER IL 32 BILLION (\$7.6 BILLION) AS RESULT OF WAR. CABINET REPORTEDLY APPROVED FY 1974/75 BUDGET OF IL 36 BILLION (\$8.6 BILLION), OF WHICH ABOUT IL 14.5 BILLION (\$3.5 BILLION)

WOULD BE FOR DEFENSE. IT IS TOO EARLY TO SAY WHETHER THIS WILL BE ONLY BUDGET FOR FY 1974/75; SUPPLEMENTARY BUDGETS HAVE BECOME STANDARD IN RECENT YEARS. AT THIS LEVEL GOI WILL BE SPENDING DIRECTLY OVER 75 PERCENT OF ISRAEL'S GROSS NATIONAL PRODUCT IN 1974 CIVILIAN EXPENDITURES PROGRAMMED WOULD BE LARGER THAN ENTIRE ORIGINAL BUDGET FOR CURRENT FISCAL YEAR, WHICH DOES NOT SUGGEST MUCH FISCAL RESTRAINT. JEWISH AGENCY EXPENDITURE WILL ALSO BE RISING. UNDER THESE CIRCUMSTANCES, WE MUST EXPECT GOVT SPENDING TO PROVIDE POWERFUL STIMULUS TO INFLATION.

8. GOI WOULD LIKE TO ROLL BACK STANDARD OF LIVING TO 1972 LEVEL, BUT POWERFUL CONSTRAINTS MAKE THIS DIFFICULT, ESPECIALLY SINCE STANDARD OF LIVING GAINS IN 1973 PRIOR TO OCTOBER WAR REACHED CLAIMED 10 PERCENT PER CAPITA IN REAL TERMS. POSSIBILITIES FOR FURTHER TAX INCREASES ARE LIMITED; NEW BUDGET REPORTEDLY WILL ABOLISH COMPULSORY DEFENSE LOAN OF 7 PERCENT OF TAXABLE INCOME, AND INTRODUCES NO NEW TAX. MOREOVER, ONLY NEW TAX IN SIGHT IS LONG-MOTTED (AND MUCH POSTPONED) VALUE-ADDED TAX. BUT VAT REQUIRES EXTENSIVE PREPARATIONS; EMBOFF SPOKE TO DIRECTOR OF STATE REVENUE FEW WEEKS AGO ON THIS SUBJECT, BUT COULD NOT GET ANYTHING SOLID ON WHEN ISRAEL MIGHT BE READY. FY 1974/75 BUDGET APPARENTLY DOES NOT INCLUDE IT. CUSTOMS DUTIES ARE BEING LOWERED YEAR-BY-YEAR OVER BROAD RANGE OF PRODUCTS AS PART OF LONG-RANGE PLAN TO EXPOSE INDUSTRY TO WORLD COMPETITION; THIS IS EXPECTED TO CONTINUE.

9. WAGE-PRICE SPIRAL IN ISRAEL HAS REACHED EPIDEMIC PROPORTIONS. THERE IS INTERREACTION BETWEEN DEMAN-PULL AND COST-PUSH VARIETIES OF INFLATION, WHICH BODES ILL FOR FUTURE. WHILE WE ARE NOT YET IN RUN-AWAY INFLATION, NEITHER CAN IT BE SAID THAT GOI IS IN CONTROL OF SITUATION. REDUCTION IN ECONOMIC ACTIVITY FUNDED THROUGH BUDGET (I.E. MORE RESTRICTIVE FISCAL POLICY) SEEMS URGENTLY REQUIRED. BUT THERE IS NO ONE IN SIGHT STRONG ENOUGH TO TELL ISRAEL THAT IT CANNOT (A) BUILD ALL HOUSES IT WANTS, (B) EXPAND DEFENSE INDUSTRIES AS DESIRED, AND (C) SUBSIDIZE LOW PRICES FOR ECONOMICALLY DEPRIVED.

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10. UNDER CIRCUMSTANCES OUTLINED ABOVE, IT IS IMPOSSIBLE TO ESCAPE IMPRESSION THAT ISRAEL IS ATTEMPTING TO DO TOO MUCH. ISRAEL'S DILEMMA IS NOT IN ESSENCE A SHORTAGE OF MONEY-- AT LEAST OF FOREIGN EXCHANGE. ISRAEL IS SHORT OF REAL RESOURCES: MANPOWER, PLANT AND EQUIPMENT, AND MANAGERIAL CAPABILITY TO COMBINE THESE TO PRODUCE GOODS AND SERVICES. THERE ARE TOO MANY UNQUESTIONABLY VALID AND DESIRABLE GOALS WHICH ISRAEL SEEKS SIMULTANEOUSLY. IN SUCH A CASE PRICES RISE TO RATION SCARECE REAL RESOURCES; THIS IS WHAT HAS BEEN HAPPENING. INFLATION IS ONE WAY OF FORCING DOWN REAL INCOMES, AND GIVEN REALITIES OF POWER (ESPECIALLY OF HISTADRUT) IT MAY BE ONLY WAY TO DO IT HERE AND NOW. WHAT IS CERTAIN, HOWEVER, IS THAT IT WILL BE AS DEEPLY RESENTED AS IF INCOME WERE TAXED AWAY, AND

THIS WILL HAVE POLITICAL FALLOUT. ALIGNMENT IS NOT PILING UP  
POLITICAL SUPPORT ON STRENGTH OF ITS MANAGEMENT OF ECONOMY; ON  
THE CONTRARY, ECONOMIC MISMANAGEMENT IS ERODING ALIGNMENTS'S  
STANDING WITH VOTERS. BRUTAL INFLATION OF 1973-74 IS DRIVING  
HOME TO ISRAELIS VULNERABILITY OF THEIR HARD WON ECONOMIC AD-  
VANCES IN RECENT YEARS AND FOCUSING THEIR RESENTMENT.

1.. WHERE THIS AFFECTS USG IS IN ITS AID PROGRAMS. OUR AID  
NOT ONLY HELPS ISRAEL COVER DEFICIT IN BOP; IT HAS EFFECT ON  
DOMESTIC ECONOMY AS WELL. GENEROSITY OF USG ASSISTANCE POLICY  
SINCE 1970 HAS ABETTED ISRAELI RELUCTANCE TO SET NATIONAL  
PRIORITIES AND ENCOURAGE FEELING THAT ALL THINGS WERE POSSIBLE.  
ISRAEL HAS INSENSIBLY SLIPPED INTO SITUATION OF ECONOMIC OVER-  
EXPANSION WHICH IS COUNTERPART OF POLITICAL AND PSYCHOLOGICAL  
OVEREXPANSION OBSERVED IN RECENT YEARS. PROGRAMS HAVE BEEN  
UNDERTAKEN WHICH FROM SOBOPTIMAL POINT OF VIEW ARE DESIRABLE,  
BUT WHEN LOOKED AT FROM STANDPOINT OF OVERALL ECONOMY ARE  
NOT FEASIBLE DUE TO SHORTAGE OF REAL RESOURCES. AMONG FACTORS  
USG AID POLICY SHOULD CONSIDER IS REAL ECONOMIC NEED, AS WELL  
AS POSSIBLE ADVERSE IMPACT OF EXCESSIVE AMOUNT OF AID. IN  
PARTICULAR, ONE SECTOR WHICH SHOULD NOT BE STIMULATED AT  
PRESENT IS HOUSING. IT WILL BE PAINFUL PROCESS FOR ISRAEL TO  
LOWER ITS SIGHTS TO ATTAINABLE GOALS, EVEN THOUGH THIS IS LONG  
OVERDUE. IMPATIENCE IS NATIONAL CHARACTERISTIC; AND ISRAELIS  
WILL NOT WELCOME STRETCHOUT IN TIME REQUIRED TO ACHIEVE THEIR  
ASPIRATIONS. NONETHELESS, IT IS NOT IN INTERESTS OF EITHER  
ISRAEL OF UNITED STATES TO NURTURE ILLUSIONS. IF WE DO SO,  
ISRAELI AID DEMANDS WILL ESCALATE, SINCE RESOURCES--REAL OR  
FINANCIAL -- DO NOT EXIST IN ISRAEL TO DO EVERYTHING ISRAEL  
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## Message Attributes

**Automatic Decaptioning:** X  
**Capture Date:** 01 JAN 1994  
**Channel Indicators:** n/a  
**Current Classification:** UNCLASSIFIED  
**Concepts:** HOUSING, BUILDING INDUSTRY, INFLATION, ECONOMIC CONDITIONS, SOCIAL PROBLEMS, ANTIINFLATIONARY PROGRAMS, FOREIGN ASSISTANCE  
**Control Number:** n/a  
**Copy:** SINGLE  
**Draft Date:** 25 FEB 1974  
**Decaption Date:** 01 JAN 1960  
**Decaption Note:**  
**Disposition Action:** RELEASED  
**Disposition Approved on Date:**  
**Disposition Authority:** cunninfx  
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**Disposition Comment:** 25 YEAR REVIEW  
**Disposition Date:** 28 MAY 2004  
**Disposition Event:**  
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